

1.1.2 OSC Staff Notice 33-731 – 2008 Compliance Team Annual Report

**OSC Staff Notice 33-731  
2008 Compliance Team Annual Report**

**Introduction**

This report is a summary of the Compliance team's activities for the 2008 fiscal year (April 1, 2007 to March 31, 2008). As in our previous reports, we discuss the results of our reviews of investment counsel portfolio managers (portfolio managers), investment fund managers and limited market dealers (LMDs) (collectively, market participants).

This year, we further enhanced the content of our report by including additional information such as:

- our roles
- how we allocate resources to oversee market participants
- how we co-ordinate with other branches of the Ontario Securities Commission (OSC) to ensure effective regulation of market participants, and
- the outcomes of our reviews

We encourage market participants to use this report as a self-assessment tool to strengthen their compliance with Ontario securities law and to improve their internal controls.

This report is divided into eight sections:

1. **Our roles.** This section describes our roles.
2. **Compliance reviews.** This section describes how we conduct compliance reviews of market participants.
3. **Compliance initiatives.** This section describes our 2008 sweep of investment fund managers and various staff notices published during the year.
4. **New and proposed rules.** This section describes new and proposed rules published by the OSC, and how they could affect the business operations of market participants.
5. **International Financial Reporting Standards (IFRS).** This section discusses how the change to IFRS affects market participants in preparing financial statements for delivery to the OSC.
6. **10 most common deficiencies among portfolio managers.** This section highlights the 10 most common deficiencies we found in our 2008 reviews of portfolio managers. We also compare these results to results from previous years.
7. **Significant deficiencies among market participants.** This section summarizes the top three significant deficiencies we found in our 2008 reviews of portfolio managers, investment fund managers and LMDs. We have also included suggested practices to help market participants improve existing procedures and establish procedures in areas where they are lacking, and to give general guidance on improving overall compliance.
8. **Outcomes of our reviews.** This section describes the various outcomes of our reviews.

**1. Our roles**

The Compliance team is part of the OSC's Compliance and Registrant Regulation Branch. Our team has 27 professional staff and consists of chartered accountants and lawyers. Our roles are to enhance investor protection and to prevent market abuse by:

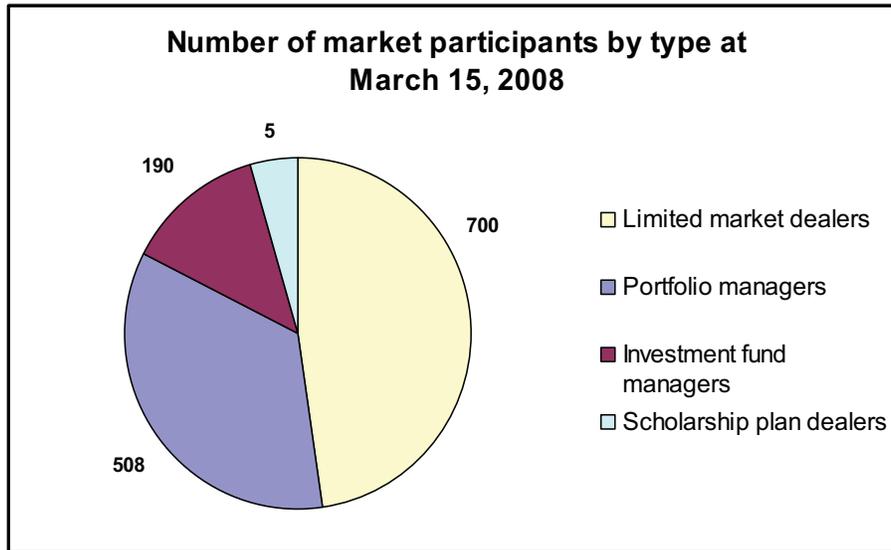
- reviewing market participants that are not members of a recognized self-regulatory organization (SRO)
- providing guidance and information to the industry on significant issues that we identify during our reviews. For example, we publish staff notices, participate in seminars and conferences and speak at conferences.
- recommending and implementing remedial action for market participants that do not comply with securities law

- determining whether standards or rules are needed for market participants
- participating in the development of rules
- creating awareness of new or proposed rules and fostering a culture of compliance, and
- co-ordinating with other branches of the OSC (for example, Investment Funds and Enforcement) to ensure effective oversight of market participants

## 2. Compliance reviews

### Profile of market participants

At March 15, 2008, we had oversight responsibility over approximately 1,400 market participants<sup>1</sup>. The following chart shows the number of market participants by type.



### Types of reviews

We conduct four types of review as part of our oversight of market participants:

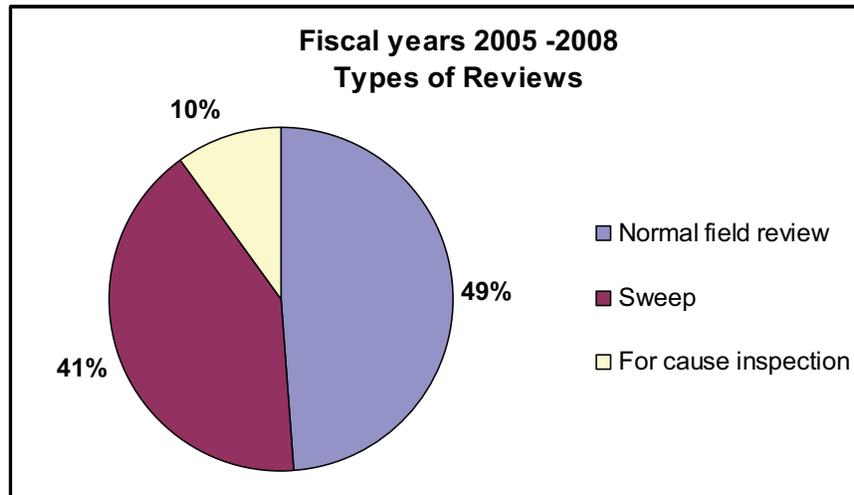
- **Normal field review.** This is a full review of a market participant's operations. We conduct these reviews on site at the market participant's location.
- **Focused review (sweep).** This on-site review focuses on a particular topic of interest to us, such as the marketing sweep of portfolio managers. For more information, please see Section 3 of the report.
- **Desk review.** This is a review of regulatory filings or other documents delivered or prepared by registrants, such as annual audited financial statements. We conduct these reviews at our office.
- **For cause inspections.** This a review of a market participant resulting from an identified issue or concern.

The number of reviews we conduct for each type of market participant in a year depends on available resources and varies from year to year.

---

<sup>1</sup> If a market participant is operating in more than one capacity, for example, as a portfolio manager and as an investment fund manager, it is considered to be two market participants for oversight purposes.

The following chart shows the average percentage of reviews conducted by type of review over the last four fiscal years:



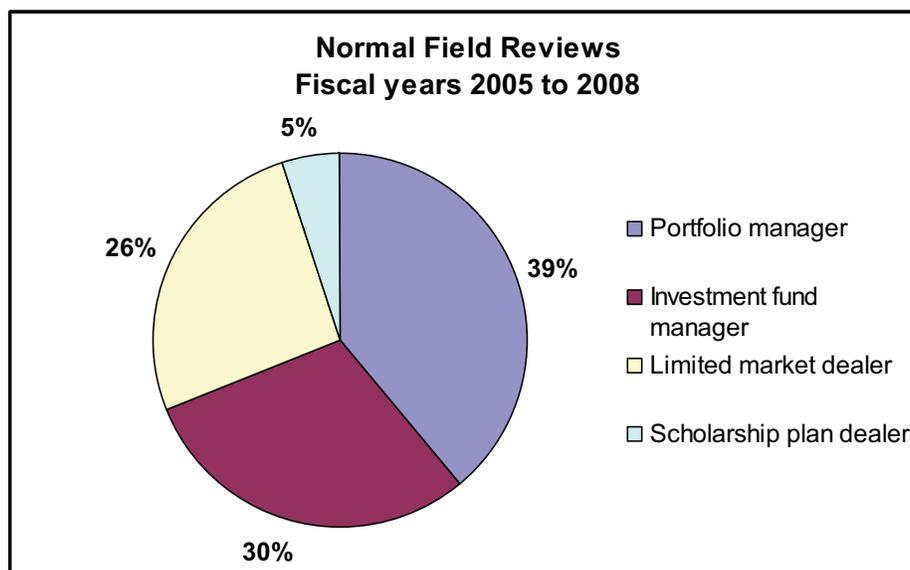
We also perform a desk review of the annual audited financial statements delivered by portfolio managers. Desk reviews are not reflected in the chart above.

In the late 1990s and early 2000s, most of our resources were dedicated to normal field reviews of market participants. In the past few years, we have shifted to performing more sweeps. We think that sweeps are a better oversight tool as they allow us to focus on a particular topic of interest and cover a large sample of market participants within a short period of time.

In the last couple of years, we have performed sweeps on the sales practices of investment fund managers, the allocation of expenses by investment fund managers and their valuation practices, and the marketing practices of portfolio managers.

We plan to conduct at least one sweep each year on each of investment fund managers, portfolio managers and LMDs. After we complete a sweep, we normally share our findings and/or provide additional guidance to the industry in a staff notice or industry report.

We perform normal field reviews on various types of market participants, including portfolio managers, investment fund managers, LMDs and scholarship plan dealers (SPDs). The following chart shows the average percentage of normal field reviews performed over the last four years by type of market participant:



### **Allocation of resources – Use of risk assessment models**

In 2002, we developed a risk assessment model to select portfolio managers and investment fund managers for normal field reviews. The risk assessment model enables us to allocate resources more effectively and efficiently by targeting those market participants with higher risk rankings.

There are four risk categories in our risk assessment models for investment fund managers and portfolio managers: high, medium-high, medium-low, and low. The overall risk ranking determines the frequency and extent of compliance oversight reviews for each market participant. For example, a market participant with a low risk ranking will likely be subject to less frequent oversight reviews than a market participant with a high risk ranking.

Since 2002, the risk assessment models and risk assessment questionnaires for both investment fund managers and portfolio managers have been enhanced and updated. We send revised questionnaires to all portfolio managers and investment fund managers every two to three years. The most recent one was sent in early 2008. From the risk assessment questionnaires, revised risk scores were generated. We conducted high risk sweeps of both investment fund managers and portfolio managers in spring 2008. For more details, please refer to Section 3 of this report.

In 2005, we introduced a risk assessment model for LMDs. Over the next year or so, we will be substantially enhancing this model.

### **Compliance field review process**

Section 20 of the Securities Act (Ontario) (the Act) gives us the authority to review books and records of a market participant to ensure compliance with Ontario securities law.

Please see the flow chart in Appendix 1 which describes the compliance field review process.

## **3. Compliance initiatives**

This section describes the sweep of investment fund managers we conducted in 2008, the various staff notices we published, the sweep of high-risk market participants we are conducting in fiscal 2009 and the new CSA compliance committee.

### **2008 sweep of investment fund managers**

In late 2007, staff from the Compliance team and from the Investment Funds Branch conducted a focused review of 26 investment fund managers.

Our objectives were to review and assess:

- the appropriateness of the methodologies used by investment fund managers to value securities in their funds' portfolios, and
- investment fund managers' practices for charging expenses to their funds

This review covered on the types of expenses allocated to the funds. We did not look at the management fee component of the management expense ratio (MER)<sup>2</sup>.

The sample of investment fund managers varied in size and offered a wide variety of products, including mutual funds, pooled funds, closed-end funds and labour sponsored investment funds. Their assets under management totalled \$159 billion at September 30, 2007.

A summary of the results is outlined below. For more information about the sweep, see Staff Notice 11-763 on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

We will continue to review the securities valuation and expense allocation practices of investment fund managers as part of our normal investment fund manager reviews.

---

<sup>2</sup> MER consists of management fees, operating expenses and any performance fees. Brokerage commissions and transaction costs are excluded from the MER calculation. The trailing commission paid to dealers and advisory fees paid to portfolio managers are usually included in the management fee of conventional mutual funds.

### **Summary of the results**

#### **Securities valuation**

The investment fund managers we reviewed generally:

- had adequate policies and procedures for valuing portfolio securities
- were using appropriate valuation methodologies for pricing securities, including securities that did not have readily available market prices, such as private issues, illiquid securities, certain types of derivatives, and restricted securities
- were consistently following the practices outlined in their valuation policies

#### **Expense allocation practices**

The investment fund managers we reviewed generally:

- followed prudent practices relating to expenses
- used appropriate methodologies to allocate expenses among multiple funds
- clearly indicated the types of expenses charged in their disclosure, including any specific or unique features, such as a fixed administration fee

#### **Staff notices issued in fiscal 2008**

Below is a summary of staff notices published in 2007 and 2008. These notices are available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

#### **OSC Staff Notice 33-729 – Marketing Practices of Investment Counsel/Portfolio Managers**

In last year's annual report, we described the focused review we conducted on the marketing practices of portfolio managers. In November 2007, we published OSC Staff Notice 33-729. The notice summarizes the results of our focused review and provides guidance to market participants on complying with applicable legislation and on best practices in the preparation and use of marketing materials.

We will continue to review the marketing practices of portfolio managers and other market participants as part of our normal field reviews. We are also considering whether further guidance is necessary.

#### **Summary of suggested practices**

The staff notice outlined suggested practices to assist portfolio managers in meeting their obligation to deal fairly, honestly and in good faith with their clients in the preparation and use of marketing materials.

We expect market participants to follow these practices when preparing marketing materials. Failure to follow them may result in inaccurate or unfair marketing materials, which we consider misleading to clients.

The suggested practices included the following:

- Portfolio managers should present performance data based on actual returns of client portfolios, not on hypothetical returns, which have a number of inherent risks and are difficult to verify.
- Performance composites should be constructed to include all portfolios with a similar investment strategy.
- Performance data should be calculated using a consistent methodology so that any comparisons are not misleading.
- Benchmarks should be relevant to the portfolio manager's investment strategy. There should be adequate disclosure to make the comparison fair and meaningful for clients.
- Portfolio managers should be able to support the claims made in their marketing materials.

### **OSC Staff Notice 33-730 – Capital Calculations for investment counsel/portfolio managers**

We review the annual audited financial statements delivered by portfolio managers. One of the things we look at is whether they are meeting their capital obligations under the Act.

In fiscal 2008, about 2% of portfolio managers were capital deficient based on their year-end audited financial statements. Also, approximately 1% of portfolio managers delivered their annual audited financial statements late. In all cases, we imposed terms and conditions on these portfolio managers.

In early 2008, we saw an increase in portfolio managers with capital deficiencies. As a result, we published OSC Staff Notice 33-730 in June 2008. The notice reminds portfolio managers of the capital requirements under the Act. It also outlines the terms and conditions that we will impose when portfolio managers deliver financial statements with a capital deficiency. We normally impose terms and conditions for six months.

The notice also reminds market participants that changes to the capital requirements are proposed under draft National Instrument 31-103 – *Registration Requirements* (NI 31-103).

#### **Fiscal 2009 sweep of high-risk market participants**

In February 2008, all portfolio managers and investment fund managers were required to complete risk assessment questionnaires. Staff reviewed the questionnaires and generated revised risk scores. In spring 2008, we conducted focused reviews of high-risk investment fund managers and portfolio managers. Our objectives were to:

- meet with the senior management of these market participants
- advise them of their overall risk ranking, and
- discuss the areas of their operations that contributed to their high risk ranking

The reviews enabled us to refine our oversight strategy for these group of registrants.

#### **CSA compliance committee**

A CSA compliance committee was established in early 2008. The mandate of the committee is to promote a harmonized approach to compliance oversight of market participants and to better share compliance resources and knowledge among CSA jurisdictions. The committee will also provide leadership to all CSA staff on approaches to compliance oversight.

## **4. New and proposed rules**

Several new and proposed rules were published during the year that could affect the operations of market participants. Brief summaries of some of these rules are set out below.

These summaries may not include all rules that affect your business. You should not consider them to be, or rely on them as, legal advice. Interpretations and comments about a rule do not replace or modify any provisions of the rule. Please refer to the actual rules, forms and companion policies, which are available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca). Where appropriate, you should consult a lawyer with expertise in securities law for advice on how to comply with the rules.

#### **Revised proposed NI 31-103**

In February 2008, the CSA published the proposed NI 31-103 for a second comment period. The proposal reflected numerous changes in response to comments received on its first publication. The purpose of the proposed rule is to harmonize, streamline and modernize the registration regime across Canada. The registration requirements are designed to protect investors from unfair, improper or fraudulent practices and enhance the integrity of capital markets. The comment period for the revised draft NI 31-103 ended on May 29, 2008. Staff are currently reviewing the comment letters.

The following is a summary of some of the changes made to the 2007 Proposal as a result of comments received in the first comment period:

- the introduction of a new category of investor, the permitted client
- reduced suitability review obligation for permitted client

- elimination of the capital and insurance requirement for those exempt market dealers that do not handle, hold or have access to client cash or assets, including cheques, and other similar instruments
- insurance requirements no longer refer only to a “financial institution bond”, but rather “bonding or insurance”
- change in the requirement to provide a relationship disclosure document to clients to a principle-based provision to provide relationship disclosure information
- the addition of transition provisions for firms and individuals

**Revised proposed National Instrument 23-102 – Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (“Soft Dollar” Arrangements) (NI 23-102)**

In January 2008, the CSA published revised proposed NI 23-102 for second comment. The comment period ended on April 10, 2008.

Proposed NI 23-102 provides a framework for the use of client brokerage commissions by portfolio managers and dealers, and proposes disclosure requirements for portfolio managers. The proposed companion policy provides additional guidance, including guidance on the types of goods and services that may be obtained with client brokerage commissions, as well as non-permitted goods and services. Staff are currently reviewing the comment letters.

**Proposed amendments to the companion policy to National Instrument 23-101 - Trading Rules (NI 23-101)**

In April 2007, the CSA published proposed amendments to National Instrument 21-101 – *Marketplace Operation*, NI 23-101 and their related companion policies. The amendments are subject to approval by the Minister of Finance and are expected to come into force in September 2008.

The following is a summary of selected amendments that affect portfolio managers:

- Portfolio managers are required to use reasonable efforts to achieve best execution.
- “Best execution” is now defined as the “most advantageous execution terms reasonably available under the circumstances”.
- The best execution requirement codifies the existing best execution obligation for portfolio managers.
- The best execution obligation goes beyond price to include other elements such as:
  - speed of execution
  - certainty of execution, and
  - the overall cost of the transaction.
- If a portfolio manager chooses to retain control of all trading decisions (for example, on direct access transactions), its best execution obligation may be similar to that of a dealer.

**Proposed amendments to National Instrument 81-106 – Investment Fund Continuous Disclosure (NI 81-106)**

NI 81-106 currently requires investment funds to calculate net asset value in accordance with Canadian generally accepted accounting principles (GAAP). However, section 3855 of the CICA Handbook, *Financial Instruments – Recognition and Measurement* would require investment funds to change long-standing industry valuation practices in order to maintain this requirement. This section is effective for years starting on or after October 1, 2006.

In June 2008, the CSA published final amendments to NI 81-106 to address this issue by permitting investment funds to have two different net asset values: one for financial statements (prepared in accordance with Canadian GAAP) and another for all other purposes (including unit pricing). The amendments remove the requirement in NI 81-106 to calculate net asset value in accordance with Canadian GAAP and replace it with a requirement to fair value assets and liabilities.

For this purpose, fair value of assets and liabilities means the current market value based on reported prices and quotations in an active market. When the current market value is not available or the investment fund manager determines that it is unreliable, fair value means a value that is fair and reasonable.

The amendments are subject to approval by the Minister of Finance and are expected to come into force in September 2008.

### **National Instrument 24-101 – *Institutional trade matching and settlement* (NI 24-101)**

Last year's annual report described NI 24-101 which came into force on April 1, 2007 and became fully effective on October 1, 2007 with a transitional phase-in period.

NI 24-101 requires dealers, portfolio managers and other trade-matching parties to establish, maintain and enforce policies and procedures to match delivery-against-payment (DAP) or receipt-against-payment (RAP) for equity and debt trades, ultimately by the end of the trade date (midnight on trade date). It also requires trade matching statements or agreements with trade matching parties, and registrant exception reporting to the securities regulatory authorities for DAP/RAP trades that are not matched within certain thresholds.

In the 2008 fiscal year, the following notices and rule relating to NI 24-101 were published:

- CSA Staff Notice 24-305 – *Frequently Asked Questions About National Instrument 24-101* assists market participants in complying with NI 24-101. (December 2007)
- CSA Staff Notice 24-306 – *NI 24-101 Institutional Trade Matching and Settlement – Exception Reporting* provides information to registrants on NI 24-101 exception reporting. (February 2008)
- CSA Staff Notice 24-307 – *Exemption from Transitional Rule: Extension of Transitional Phase-in Period in NI 24-101* and OSC Rule 24-502 – *Exemption from Transitional Rule: Extension of Transitional Phase-in Period in NI 24-101* defer the current requirement in NI 24-101 to match DAP/RAP trades by midnight on the trade date by 24 months to July 1, 2010. They also extend the transitional phase-in period in NI 24-101 for the registrant exception reporting requirement by an additional 24 months to January 1, 2012. (April 2008)

## **5. International Financial Reporting Standards (IFRS)**

In February 2008, the Canadian Accounting Standards Board confirmed that all publicly accountable enterprises will be required to report their financial results under IFRS for fiscal periods beginning on or after January 1, 2011.

IFRS will replace current Canadian standards and interpretations as Canadian generally accepted accounting principles. Non-publicly accountable enterprises are permitted, but not required, to adopt IFRS in 2011.

CSA staff is planning on issuing a notice shortly setting out its views on which registrants are required to use IFRS starting in 2011.

## **6. 10 most common deficiencies among portfolio managers**

Each year, we conduct normal field reviews of portfolio managers. The portfolio managers we select for review have various business models and vary in assets under management<sup>3</sup>.

This section sets out the 10 most common deficiencies that we found in our 2008 reviews. These are the deficiencies that we find most frequently in our reviews.

The table below shows the 10 most common areas of deficiency compared with the previous three years.<sup>4</sup> A number of related issues are included under each category. A portfolio manager is included in a category if it had at least one issue in that area.

---

<sup>3</sup> The median assets under management of the portfolio managers reviewed was \$261 million in the 2008 fiscal year, \$113 million in the 2007 fiscal year, \$136 million in the 2005-06 fiscal years, and \$205 million in the 2004 fiscal year.

<sup>4</sup> We also identified issues in many other areas, including statement of client's portfolio, conflicts of interest, cross transactions, soft dollars, related registrant disclosure, annual consent to trade securities of related and connected issuers, compliance function, adhering to the terms and conditions of registration, insurance coverage, exempt securities, early warning and insider trading reporting, proxy voting, referral arrangements, United Nations Suppression of Terrorism monthly reporting, internal controls, segregation of duties, trust accounts, agreements with service providers, confidentiality agreements and "holding out" issues.

Common deficiency	Ranking			
	2008	2007	2005-06 <sup>5</sup>	2004
1. Policies and procedures manual	1	7	1	1
2. Marketing	2	4	2	8
3. Portfolio management, including advisory contracts	3	5	9	4
4. Registration issues	4	10	10	7
5. Capital calculations	5	9	4	6
6. Policy for fairness in the allocation of investment opportunities	6	2	6	2
7. Maintenance of books and records	7	1	3	5
8. Personal trading	8	8	7	9
9. Business continuity plan (BCP) <sup>6</sup>	9	n/a	n/a	n/a
10. Know your client (KYC) and suitability information	10	3	8	10

### 2008 rankings

The 10 most common deficiencies for 2008 were substantially the same as previous years, although the order of the rankings changed. This was largely due to the differences in the composition of the sample. This year, the sample included a mix of large and small firms with median assets under management of \$261 million. Last year, our sample was primarily focused on smaller portfolio managers with median assets under management of \$113 million.

In our experience, smaller portfolio managers tend to have more issues relating to books and records, KYC and suitability information. Larger portfolio managers generally have adequate processes in place to document and collect KYC information, but they tend to have issues with not updating their policies and procedures manual and/or using a trade name instead of the legal registered name in their marketing brochures. These differences explain why the ranking for deficiencies relating to policies and procedures and registration issues moved up in 2008 and the ranking for deficiencies relating to KYC and suitability information moved down.

### Suggested practices

We have not included a detailed discussion about the 10 most common deficiencies because they were substantially the same as previous years. You can find more information about these deficiencies and suggested practices for addressing them in our previous annual reports. They are available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

We are also planning to post on the OSC website a separate summary of the 10 most common deficiencies of portfolio managers and suggested practices in the near future. We encourage portfolio managers to use this as a self-assessment tool to strengthen their compliance with Ontario securities law.

## 7. Significant deficiencies among market participants

If we find significant deficiencies in a market participant's operations, we identify them in the deficiency report to enable senior management to focus on the key issues identified. The identification of significant deficiencies also helps to highlight areas of regulatory concern so that appropriate action can be taken to improve compliance.

We have established various criteria to assess whether a deficiency is significant, including:

- risk to client assets

<sup>5</sup> The results for the 2005 and 2006 fiscal years are combined.

<sup>6</sup> BCP is a new top 10 common deficiency this year. It was added to our review program in 2007.

- conflicts of interest
- misleading information to clients
- ineffective compliance structure

We also take into account other factors, including:

- current issues, such as best execution and referral arrangements
- the frequency of findings
- the impact of the deficiency on the market participant's operations

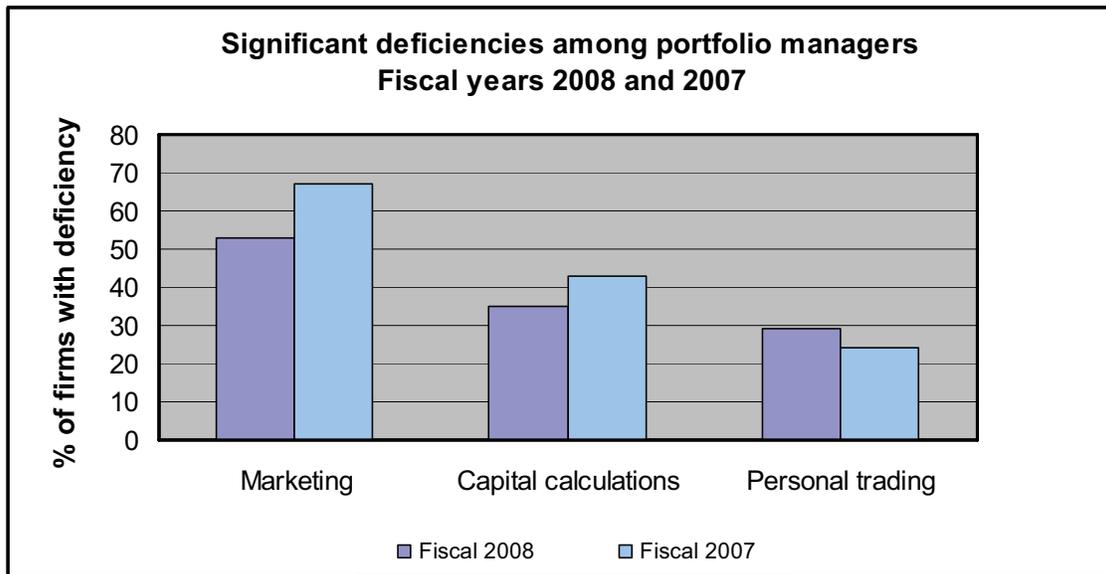
The following sections summarize the top three significant deficiencies for fiscal 2008 of portfolio managers, investment fund managers and LMDs.

**Significant deficiencies – portfolio managers**

Our normal field reviews of portfolio managers in the 2008 fiscal year resulted in an average of 14 deficiencies per firm reviewed. An average of four or 29% of these deficiencies were significant.

The chart below shows the top three significant deficiencies that we found among portfolio managers, compared with the 2007 fiscal year. Please note that the top three significant deficiencies in fiscal 2008 are not the same as those in the previous fiscal year.<sup>7</sup>

We will continue to monitor and focus on these areas in our normal field reviews.



**Note:** The percentage of deficiencies is calculated based on the portfolio manager reviews performed in the 2008 fiscal year and does not represent the whole population of portfolio managers.

**1. Marketing**

Marketing remains the top significant deficiency. About 53% of the portfolio managers reviewed had significant deficiencies in this area. However, the percentage of deficiencies in this area improved by 14% in the 2008 fiscal year. We believe this improvement may be at least partly due to the publication of OSC Staff Notice 33-729 – *Marketing Practices of Investment*

<sup>7</sup> The top three significant deficiencies in the 2007 fiscal year were marketing, KYC and suitability information, and capital calculations.

*Counsel/Portfolio Managers* (OSC Staff Notice 33-729), which provides guidance to market participants on complying with applicable legislation and best practices in the preparation and use of marketing materials. OSC Staff Notice 33-729 is available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

Section 2.1 of OSC Rule 31-505 – *Conditions of Registration* (OSC Rule 31-505) requires registrants to deal fairly, honestly and in good faith with their clients. This provision is a broad principle that applies to registrants generally. We expect registrants to apply it to all areas of their activities, including market practices and marketing materials.

We found the following marketing-related issues:

#### **Improperly constructed performance composites**

Some portfolio managers did not have adequate procedures and controls to ensure that performance composites were properly constructed. For example, they did not include all fee-paying, discretionary accounts with similar investment objectives and strategies in the composite.

#### ***Suggested practices***

- Establish policies and procedures for constructing composites appropriately and consistently. This includes how to treat terminated portfolios, new portfolios, and portfolios that have changed strategies and switched composites.
- Include in the composite all portfolios that meet the criteria.
- Calculate composite returns by asset weighting the returns of individual portfolios.

#### **Inadequate disclosure relating to performance data**

Some portfolio managers provided inadequate disclosure relating to performance data. For example, they did not disclose whether performance returns were gross or net of fees, or the names of the composites or pooled funds that the performance returns related to. Others provided inadequate disclosure of the differences between client account returns and the benchmarks to which they are compared.

#### ***Suggested practices***

- Provide clear and adequate disclosure in marketing materials to ensure that performance data is meaningful and comparisons are fair and not misleading. This includes providing:
  - a description of the investment strategy that is reflected in the performance data
  - a statement about whether returns are net or gross of portfolio management fees and/or other expenses
  - key information about client portfolios in the composite, such as minimum asset level
  - benchmarks that are relevant to the investment strategy, including the full name of the benchmark and the components of any blended benchmarks.
- Update marketing materials regularly to ensure all information is complete, accurate and not misleading to clients.
- Establish and enforce procedures for preparing, reviewing and approving marketing materials.
- Establish guidelines for preparing performance data, using benchmarks and constructing composites.
- Have someone independent of the preparer review and approve marketing materials for accuracy and compliance with securities law.

#### **Hypothetical performance data**

Some portfolio managers presented hypothetical performance data that may be misleading to clients. For example, they calculated hypothetical performance data based on benchmark returns or returns of the portfolio managers' model portfolios, not on the actual performance of client accounts. In addition, hypothetical performance data was presented for a fund before its initial distribution and was presented as if it was the fund's return.

### ***Suggested practices***

- Present actual—not model—performance data for an investment strategy.
- Disclose the methodology and assumptions used to calculate hypothetical performance data.
- Use back-tested performance data only if it is based on actual fund performance (either in a fund-of-funds situation or where a newly created fund follows the same investment strategy of an existing fund) and only under certain conditions as disclosed in OSC staff notice 33-729.

### **Exaggerated claims**

Some portfolio managers made exaggerated claims about their skills, performance or services. For example, they included statements such as “proven performance, superior to index returns” and “our superior performance” in marketing materials. They did not provide adequate information to support the claim and to ensure that clients were not misled.

### ***Suggested practices***

- Substantiate all claims made in marketing materials. Information supporting the claim should be referenced to where the claim is made in the marketing material so that it is easily accessible by clients.
- Ensure that all claims accurately reflect the portfolio manager’s performance, skills, education, portfolio management experience and services.

## **2. Capital calculations**

About 35% of the portfolio managers reviewed had significant deficiencies in this area. Overall deficiencies in capital calculations improved by 8% in the 2008 fiscal year. This was because our 2008 review included a mix of large and small firms, compared to 2007 review, which focused on smaller portfolio managers. Larger portfolio managers tend to have adequate processes and procedures for calculating monthly capital. Approximately 43% of the portfolio managers reviewed in 2007 had issues with capital calculations.

We found the following issues relating to capital calculations:

- Capital calculations were prepared using:
  - financial statements that were not in accordance with Canadian GAAP
  - an incorrect working capital base
- Capital calculations were not prepared on a monthly basis or were not prepared at all.
- There was a lack of evidence that someone independent of the preparer reviewed the capital calculations.

Portfolio managers are required to prepare monthly capital calculations within a reasonable period of time after each month end (Regulation 113(3)). Capital calculations must be based on monthly financial statements prepared in accordance with Canadian GAAP. If a portfolio manager becomes capital deficient, it is required to inform the OSC immediately and to correct the capital deficiency within 48 hours.

We impose terms and conditions on all registrants that are identified as capital deficient. The terms and conditions include providing us with unaudited financial statements and capital calculations each month for a six-month period.

### **Suggested practices**

- Calculate the capital position on a monthly basis and prepare it using financial statements prepared in accordance with Canadian GAAP.
- Maintain copies of the capital calculations.
- Have someone independent of the preparer review the calculations for accuracy.
- Keep a record of the review.

- Inform the OSC immediately if the capital position becomes deficient.

### 3. **Personal trading**

Personal trading deficiencies increased slightly in the 2008 fiscal year to 29% from 24% in the 2007 fiscal year.

We found the following issues related to personal trading:

- Personal trading policies and procedures were not established.
- Personal trading policies were not adequately enforced. For example, portfolio managers did not have complete lists of employees' personal trading accounts, they did not always review personal trading statements of employees to ensure compliance with the personal trading policy, and employees did not always obtain pre-approval to trade.
- There was a lack of evidence that the personal trading of employees had been reviewed.

It is prudent business practice for portfolio managers to establish and enforce a personal trading policy for all employees. This helps to ensure compliance with Part XXI - *Insider Trading and Self-Dealing* of the Act, and prevent and detect conflicts of interest and abusive practices.

#### **Suggested practices**

- Develop and implement personal trading policies and procedures and distribute them to all employees and access persons. Include things, such as blackout periods, requirement for pre-approval of access persons' personal trades, and timely review of brokerage statements.
- Require all access persons to acknowledge in writing each year that they understand and will follow the personal trading policies.
- Require all access persons to direct their brokers to send their account statements directly to the officer responsible for monitoring the personal trading policy.
- Keep a record of personal trade pre-approvals and brokerage statements of access persons.
- Have the compliance officer review all personal trading records.

#### **Significant deficiencies – investment fund managers**

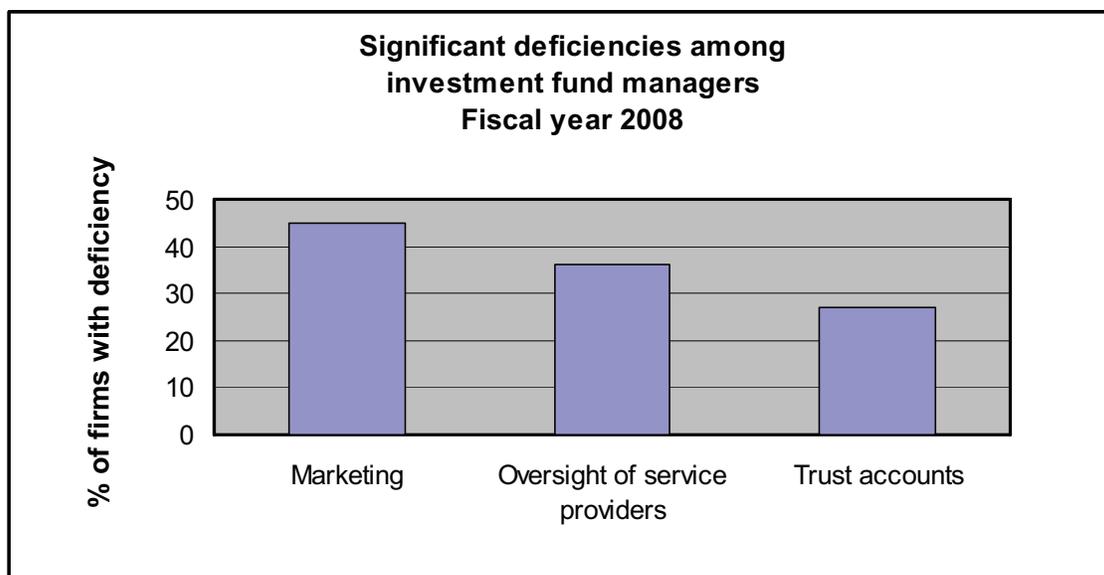
The field reviews of investment fund managers that we conducted in the 2008 fiscal year resulted in an average of seven deficiencies per firm reviewed. An average of two or 29% of these deficiencies were significant.

The following chart shows the top three significant deficiencies of investment fund managers for the 2008 fiscal year<sup>8</sup>.

We will continue to monitor and to focus on these areas in our normal field reviews.

---

<sup>8</sup> Comparative figures are not available as we started to track significant deficiencies of investment fund managers in Fiscal 2008.



**Note:** The percentage of deficiencies is calculated based on the investment fund manager reviews performed and does not represent the whole population of investment fund managers.

**1. Marketing**

Marketing was the top significant deficiency among the investment fund managers that we reviewed in the 2008 fiscal year. About 45% of the investment fund managers reviewed had significant deficiencies in this area. The issues were similar to those of portfolio managers. They included:

- **Inappropriate use of benchmarks.** Some investment fund managers compared the returns of their funds to benchmarks that were inappropriate or not relevant. For example, they used benchmarks that differed significantly from the composition and investment strategy of the funds. They did not provide adequate disclosure to ensure that the comparison was fair and not misleading. They presented fund returns in a different currency than the benchmark, and did not disclose the composition of blended benchmarks.
- **Inappropriate or incorrect performance data.** Some investment fund managers did not calculate performance data properly or presented performance data inappropriately. For example, performance data was not presented with all the required warning disclosures and/or all the required time periods. Hypothetical performance data was presented for periods before the fund's initial distribution.
- **Exaggerated claims.** Some investment fund managers made exaggerated claims about their performance, skills or services. For example, they made statements such as "superior results over the long term", "outstanding performance", and "[use of] superior portfolio managers" in marketing materials. They did not provide adequate information to support these claims and to ensure that clients were not misled.

Subsection 116(1) of the Act requires investment fund managers to exercise their duties honestly, in good faith and in the best interests of the investment fund. In doing so, investment fund managers must exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. Investment fund managers must prepare marketing materials in accordance with the standard of care under subsection 116(1) of the Act. In addition, subsection 15.2(1) of National Instrument 81-102 – *Mutual Fund Distributions* (NI 81-102) provides that no sales communication shall be untrue or misleading, or include a statement that conflicts with information that is contained in the simplified prospectus or annual information form of a mutual fund.

**Suggested practices**

- Marketing materials must include information that is accurate, complete and not misleading.
- Include the warning disclosures required by NI 81-102 in mutual fund sales communications.

- Performance ratings or rankings for a mutual fund must be presented for all periods where standard performance data is required.
- Establish and enforce procedures for preparing, reviewing and approving marketing materials. This includes having marketing materials reviewed by someone independent of the preparer.

#### ***Oversight of service providers***

About 36% of investment fund managers reviewed had significant deficiencies in this area. Investment fund managers are ultimately responsible for the services provided by the service providers. However, some investment fund managers that outsourced the fund accounting, trust accounting and/or transfer agency functions did not have adequate oversight procedures.

We found the following issues relating to oversight of service providers:

- There was inadequate procedures to ensure that service providers were performing the outsourced functions properly.
- Investment fund managers had limited communication with service providers. For example, they communicated with service providers on an ad-hoc basis.
- There was a lack of evidence that investment fund managers were reviewing outsourced functions to ensure that service providers were fulfilling their duties.

In accordance with the standard of care under subsection 116(1) of the Act, investment fund managers should have appropriate procedures in place to monitor the functions that they outsource and to ensure that these functions are performed properly.

#### **Suggested practices**

- Establish guidelines on monitoring each outsourced function, including:
  - how often the investment fund manager and service provider will communicate
  - types of reports the service provider will provide, and
  - how often the investment fund manager will review the reports
- Establish guidelines with service providers on the types of issues that should be escalated and when they should be escalated.
- Maintain evidence of reviews of outsourced functions.

#### ***Trust accounts***

About 27% of investment fund managers reviewed had significant deficiencies in this area. We found the following issues relating to trust accounts:

- Accounts were not labelled as a “trust account”.
- Accounts were non-interest bearing.
- Interest earned in the account was not allocated to funds pro-rata based on cash flow.
- Accounts were in an overdraft position.
- Commingling of operating monies in the accounts.

Part 11 of NI 81-102 outlines the requirements for trust accounts. It requires the monies received for investment in, or on the redemption of, securities of a mutual fund to be accounted for separately and deposited in a trust account established and maintained in accordance with section 11.3 of NI 81-102. Section 11.3 of NI 81-102 lists the requirements for these trust accounts.

**Suggested practices**

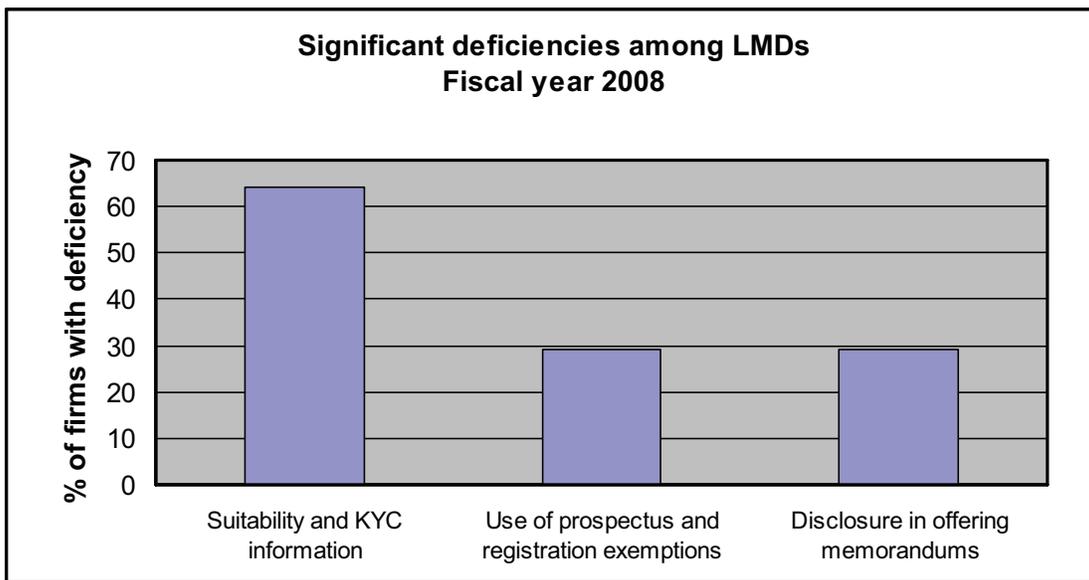
- Establish an account for holding client funds in trust.
- Have the financial institution label the account as a “trust account”.
- Ensure that the account earns interest at rates equivalent to comparable accounts of the financial institution.
- Interest earned on cash held in the trust account should be paid to security holders or to the funds pro-rata based on cash flow at least annually.
- Trust accounts should not be in an overdraft position.

**Significant deficiencies – LMDs**

The field reviews of LMDs we conducted in the 2008 fiscal year resulted in an average of nine deficiencies per firm reviewed. An average of three or 33% of these deficiencies were significant.

The following chart shows the top three significant deficiencies among LMDs<sup>9</sup>.

We will continue to monitor and focus on these areas in our normal field reviews.



**Note:** The percentage of deficiencies is calculated based on the LMD reviews performed in the 2008 fiscal year and does not represent the whole population of LMDs.

***Suitability: Know your client (KYC) and know your product (KYP)***

The top significant deficiency for LMDs was in the area of collecting the KYC information necessary to make suitability determinations. About 64% of the LMDs reviewed had significant deficiencies in this area. Dealers are required under section 1.5 of OSC Rule 31-505 to collect and document sufficient and appropriate KYC information to ensure that trades are suitable for clients. This requirement applies both to trades in securities under a prospectus exemption and to trades in prospectus-qualified securities.

To ensure that trades are suitable for their clients, LMDs must have a sufficient understanding of the investment products they are recommending and their clients’ circumstances. LMDs may not contract out of their duty to ensure that trades are suitable for clients.

<sup>9</sup> Comparative figures are not available as we started to track significant deficiencies of LMDs in Fiscal 2008.

We found the following issues relating to KYC information and the suitability determination:

- LMDs did not collect or document KYC information necessary for the suitability determination.
- KYC information was inadequate or incomplete.
- LMDs tried to contract out of their duty to ensure that trades are suitable for their clients.

**Suggested practices**

- LMDs should collect and document KYC information for their clients. This includes the client's investment needs and objectives, risk tolerance, investment knowledge, and financial circumstances (such as annual income and net worth).
- Clients should sign and date their KYC information.
- The salesperson and the compliance officer should review and approve the client's KYC documentation to ensure that the KYC information collected from the client is sufficient for the LMD to make the suitability determination and is appropriate for the types of securities being traded.
- LMDs should understand the pertinent characteristics of the securities being traded or recommended in order to make an appropriate suitability determination. This includes understanding the structure, features, risk and return profile, liquidity restrictions and full costs and any eligibility requirements of each product.

***Use of prospectus and registration exemptions***

About 29% of the LMDs reviewed had significant deficiencies in this area. LMDs are responsible for determining whether a registration and/or prospectus exemption is available for a particular trade.

Section 1.10 of the Companion Policy to NI 45-106 *Prospectus and Registration Exemptions* (45-106CP) states that a person trading securities is required to determine whether an exemption is available for a particular trade. Commonly used exemptions are the accredited investor (AI) exemption and the minimum amount investment exemption (where the purchaser, purchasing as principal, makes a cash purchase of a security for an acquisition cost of not less than \$150,000).

Many LMDs rely on the AI exemption. Section 1.10 of 45-106CP states that, before discussing the particulars of the investment with the purchaser, the LMD should discuss with the purchaser the various criteria necessary to qualify as an AI and determine whether the purchaser meets any of the criteria. It is not appropriate for the LMD to assume that the AI exemption is available based only on a form of subscription agreement that states that the purchaser is an AI. The LMD should ensure that the purchaser specifies how he or she fits within the AI exemption.

45-106CP also requires the dealer trading securities under an exemption to retain all necessary documents to evidence that the dealer properly relied upon the exemption.

Some LMDs did not adequately determine, or maintain evidence, that an appropriate exemption was available for their clients' trades. Examples included:

- Clients indicated they were an AI without specifying what category of the AI definition they met.
- Clients indicated they were an AI but specified an incorrect category of the AI definition.
- Clients did not sign the exemption certificates.
- The exemption used was not consistent with that client's KYC information.

**Suggested practices**

- LMDs should ensure that the exemption category is appropriate for the client and the trade. They should maintain the documents necessary to show that they properly relied upon the exemption.
- If the LMD is relying on an AI exemption, the LMD should ensure that:
  - the client has completed, signed and dated an exemption certificate
  - the exemption certificate shows the category of the AI definition the client qualifies for, and

- the AI category is appropriate for the client and is consistent with the client's KYC and suitability information
- The salesperson and the compliance officer should review the completed client documentation, including the KYC form and exemption certificate, to ensure that the LMD is relying on an appropriate exemption category. They should also ensure that all necessary documents are retained.
- LMDs should establish and enforce policies and procedures on determining whether an exemption is available and on maintaining supporting documentation.

#### ***Disclosure in offering memorandums (OMs)***

About 29% of the LMDs reviewed had significant deficiencies in this area. Subsection 2.1(1) of OSC Rule 31-505 requires dealers to deal fairly, honestly and in good faith with their clients. LMDs should ensure that all OMs provided to clients have adequate and balanced disclosure about the securities being sold, including risk factors, fees and conflicts of interest. LMDs should also ensure that all statements and facts in OMs are accurate.

Under section 6.3 of OSC Rule 45-501 – *Ontario Prospectus and Registration Exemptions*, the selling security holder must describe the rights under section 130.1 of the Act in an OM. These rights include the right of action for damages against the issuer and selling security holder, and the right of rescission.

We found the following issues relating to disclosure in OMs:

- Fee arrangements were not disclosed. These included compensation arrangements between the issuer and the dealer.
- Risk factors were not disclosed or were inadequately disclosed. Risk factors will vary depending on the type of security offered and may include the risk of whole or partial loss of the investment, the risk of fluctuations in the value of the investment, the liquidity of the investment (including any resale restrictions), credit risk, interest rate risk and currency risk.
- Disclosure of conflicts of interest was inadequate. For example, OMs did not adequately describe all the relationships between the issuer and the dealer, such as having common officers and/or directors.
- OMs contained inaccurate statements and facts. For example, OMs contained inaccurate descriptions of the proficiencies and employment history of the officers and directors.
- OMs did not disclose the statutory right of action for damages against the issuer and selling security holder and the right of rescission.

#### **Suggested practices**

LMDs should ensure that all relevant information relating to the securities they recommend to prospective purchasers is disclosed in the OM. This includes, but is not limited to, fee arrangements, risk factors, conflicts of interest, and rights of action for damages or rescission.

### **8. Outcomes of our reviews**

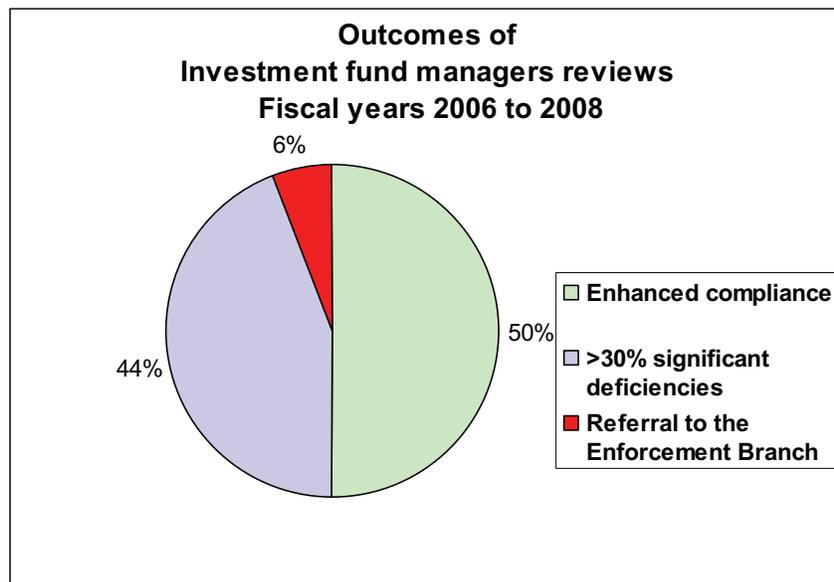
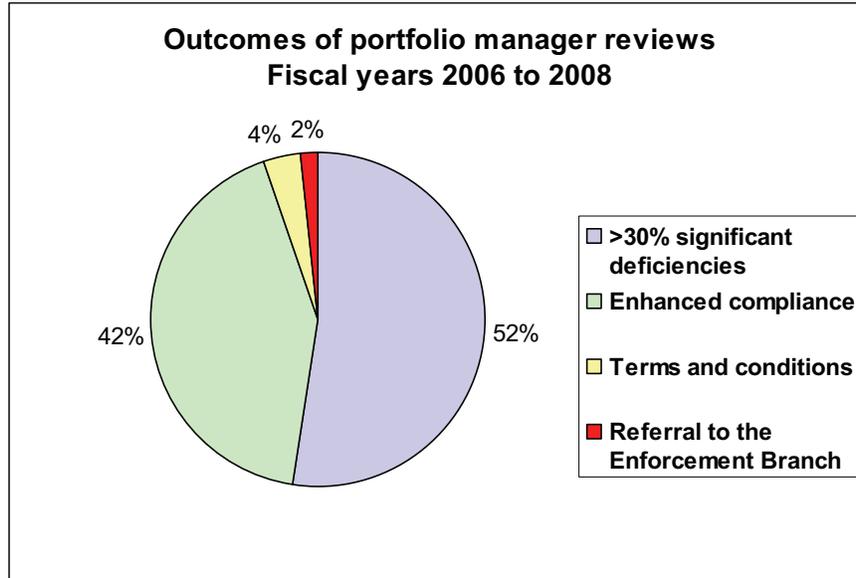
After we complete a review, we send a report to the market participant outlining the deficiencies that we found. A market participant generally has 30 days to respond in writing to the report. The response should set out the steps that the market participant will take, or has taken, to address the deficiencies.

Listed below are the possible outcomes from our reviews. In most cases, the report is sufficient to address the deficiencies. In the other cases, we may have to take further action to ensure that market participants comply.

- **Enhanced compliance.** At the end of each review, we issue deficiency reports to the market participants identifying areas of non-compliance with securities law. The majority of our reviews result in limited follow up work as all deficiencies are resolved to our satisfaction. Our compliance reviews enhance the overall compliance of these market participants.
- **Terms and conditions.** We may impose terms and conditions to ensure a registrant complies with Ontario securities law. Registrants have the opportunity to be heard before terms and conditions are imposed by the Director. Terms and conditions are posted on the OSC website.

- **Monitoring of market participants with greater than 30% significant deficiencies.** We track and monitor a market participant when 30% or more of the deficiencies found in its review are significant. We may conduct a follow-up review, if necessary.
- **Referral to the Enforcement Branch.** If we identify a serious breach of Ontario securities law, we will immediately discuss our findings with the Enforcement Branch of the OSC. The Enforcement Branch will assess the case and determine an appropriate course of action.

The following charts show the various outcomes of our reviews of portfolio managers and investment fund managers during the last three fiscal years:



**For more information**

If you have questions or comments about this report, please contact one of the following people:

Carlin Fung, CA  
Senior Accountant, Compliance  
E-mail: [cfung@osc.gov.on.ca](mailto:cfung@osc.gov.on.ca)  
Phone: 416-593-8226

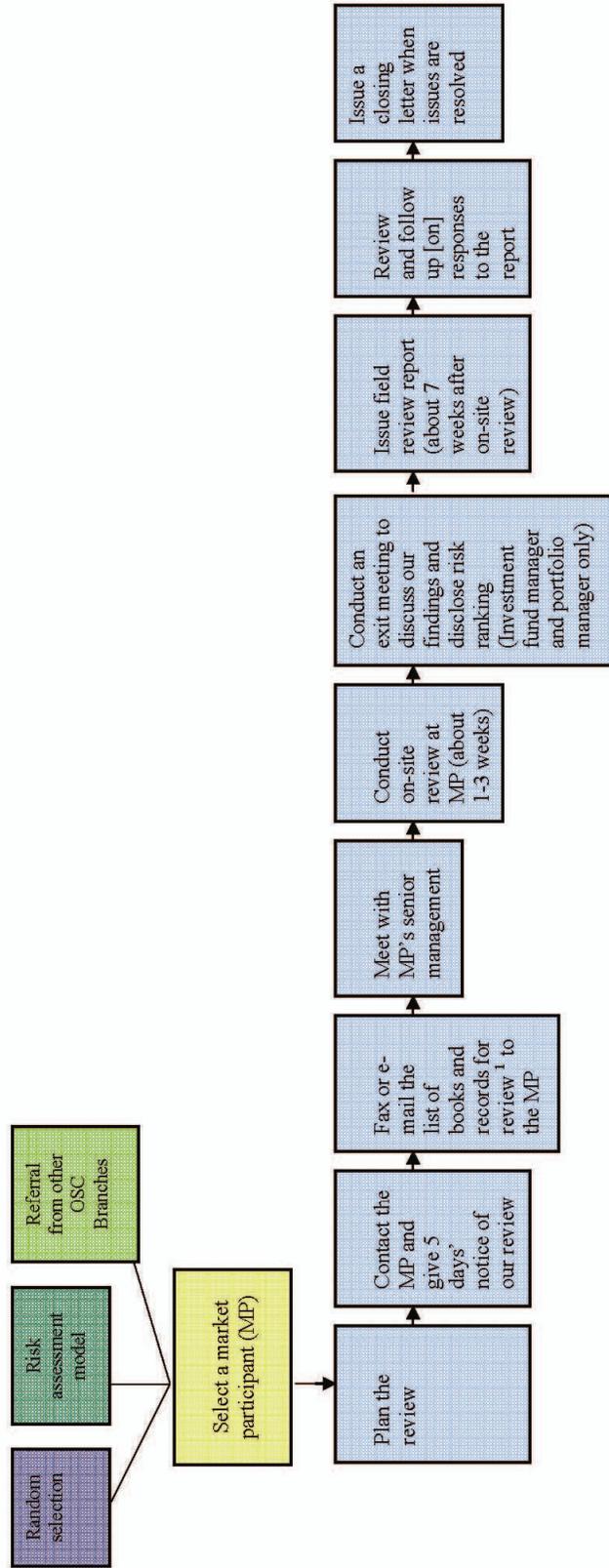
Jennifer Li, CA  
Accountant, Compliance  
E-mail: [jli@osc.gov.on.ca](mailto:jli@osc.gov.on.ca)  
Phone: 416-593-3658

Marriane Bridge, CA  
Manager, Compliance  
E-mail: [mbridge@osc.gov.on.ca](mailto:mbridge@osc.gov.on.ca)  
Phone: 416-595-8907

September 5, 2008

Appendix 1

# Compliance Field Review Process



<sup>1</sup> The list of books and records for investment fund managers, portfolio managers and LMDs is available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca)